

General Information Letter: Guaranteed payments under IRC Section 707(c) are distributions of partnership income, and must be allocated under IITA Section 305.

July 11, 2001

Dear:

This is in response to your letter dated June 27, 2001, in which you request a letter ruling. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at [www.revenue.state.il.us](http://www.revenue.state.il.us).

In your letter you have stated the following:

xxxxxxxxxxxxxxxxxxxxxxxxxxxxx has been engaged by our client, xxxxxxxxxxxxxxxxxxxx xxxxxxxxxxxxxx ("xxxxxxx" or "Partnership"), to request a letter ruling from the Department of Revenue regarding an Illinois Income Tax filing methodology for resident and non-resident partners of a non-Illinois partnership under the circumstances described below. To the best of our knowledge and that of xxxxxxxx, the Department has not previously ruled on the same or a similar issue for xxxxxxxx or a predecessor, and neither have we nor xxxxxxxx previously submitted the same or a similar issue to the Department which was withdrawn before a letter ruling was issued. xxxxxxxx does not have an audit or litigation pending with the Department.

#### **STATEMENT OF FACTS**

xxxxxxx is a North Carolina LLC, treated as a partnership for federal and Illinois income tax purposes with a fiscal year-end of September 30. As of September 30, 2000, the Partnership had seventeen members (or partners), two of which are corporations. The individual partners are investment brokers, operating their own businesses in their respective states of residence. One of the partners is a resident of Illinois who has an office in Illinois. Each broker is responsible for his or her own business expenses, including rent and supplies. Collectively, these brokers generate sales in multiple states, including Illinois. The commissions are deposited into the Partnership account, not the individual broker's (or partner's) bank account.

Members are compensated on a percentage of the commission and fee based revenue they generate in the form of a guaranteed payment. The guaranteed payment is included as income on the member's personal income tax return and the Partnership receives a corresponding tax deduction. The guaranteed payments received by the individual nonresident members relate to activities performed by that member exclusively outside Illinois.

In addition, members include in income their proportionate share of the Partnership's income or loss based on their ownership percentage. As a member of the Partnership, each member is required to take into account his distributive share of the Partnership's income, gain, loss and deductions, whether or not distributed, in accordance with the

provisions of the Partnership agreement. The Partnership incurred a loss of approximately \$2 million for the year ended September 30, 2000.

## **ANALYSIS OF RELEVANT AUTHORITY**

Section 201(c) of the Illinois Income Tax Act ("IITA") imposes a Personal Property Tax Replacement Income Tax, measured by net income on every corporation, partnership and trust. Therefore, a partnership pays the Replacement Tax on Illinois net income, which is federal taxable income adjusted by Illinois additions and subtractions and then apportioned or allocated to Illinois. Section 502(f) of the IITA allows every partnership to file a composite Illinois return on behalf of some or all of its non-resident individual partners, rather than requiring those persons to file separate Illinois income tax returns.

Regulation Section 100.5130(a)(2) provides that the composite income of a partnership shall be computed by first computing the partnership's base income, and then including in composite income the entire partnership share of such base income of each resident partner joining in the composite return and the partnership share of the portion of such base income allocable to Illinois per the Form IL-1065 of each non-resident partner joining in the composite return. However, the base income of the partnership for this purpose is computed without regard to the addition modification for guaranteed payments to partners that are not included in the composite return.

Applying the above principles to xxxxxxxx would result in its composite return including guaranteed payments made to non-resident partners who have not personally engaged in any activities within Illinois. xxxxxxxx would be required to withhold individual income tax on a non-resident composite basis. Each non-resident partner would be required to file a non-resident return seeking a full refund of tax on the basis that the guaranteed payments are entirely attributable to sources outside Illinois.

## **REQUEST FOR RULING**

With respect to the guaranteed payments, each partner is compensated on the basis of his or her independent efforts. If one partner operates his or her business efficiently and generates significant revenue, there is a corresponding effect on the guaranteed payment received by that partner. In fact, each partner (or broker) essentially operates as his or her own franchise. In essence, the rewards of the broker guarantee payments are not traced directly to the partnership medium. Each non-resident individual partner is truly engaged in a business apart from holding an interest in the Partnership. Therefore, the Partnership does not operate as a single business. Rather, it operates as multiple independent businesses. On that basis, the non-resident partners' guaranteed payments should be viewed as income from sources outside Illinois. This is the appropriate result because the non-resident brokers' net income from guaranteed payments is not derived from Illinois and is not otherwise fairly attributable to activities within Illinois. Because the guaranteed payments can be traced to the efforts of the non-resident partners' commissions and fees in other states, that portion of net income representing guaranteed payments should not be taxed by Illinois.

Our request relates solely to the guaranteed payments received by non-resident partners. If the Partnership has income from operations, the Partnership will remit the state income tax for individual non-resident partners relating to the amount of partnership income apportioned to Illinois for each partner. With respect to the guaranteed payment, we request the Department to rule that it will not require the Partnership to remit income taxes on the amount of guaranteed payments made to nonresident individual members based on the facts represented above.

## **Response**

Section 305(a) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) provides:

The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State.

As explained in House Rep. No. 1337, 83d Cong., 2nd Sess., *reprinted at* 1954 U.S. CODE CONG. & ADMIN. NEWS 4025, 4091-99 and 4366-71, prior to 1954, the federal income tax law treated "guaranteed payments" as if each were just another distribution of partnership income. This treatment caused accounting problems when the sum of the guaranteed payments exceeded partnership taxable income for a given year, and Congress determined such accounting to be "unrealistic and unnecessarily complicated." Accordingly, in the Internal Revenue Code of 1954, Congress enacted Section 707(c) of the Internal Revenue Code, which treats guaranteed payments to a partner as a deduction to the partnership as a whole, provided the usual requirements for deductibility are met.

Section 707(c) states that:

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, **but only for the purposes** of section 61(a)(relating to gross income) and, subject to section 263, for purposes of section 162(a)(relating to trade or business expenses. (emphasis added)

Treas. Reg. § 1.707-1(c) explains further that:

Guaranteed payments are considered as made to one who is not a member of the partnership, only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). . . . **For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income.** Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross

income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. (emphasis added)

The "ordinary income" of a partnership referred to in this regulation is the partnership's income excluding amounts required to be separately taken into account by the partners, such as capital gains and losses, dividends, charitable deductions, etc. See Sections 702(a) and Section 703(a) of the Internal Revenue Code.

Accordingly, from the perspective of a partner receiving a guaranteed payment, the guaranteed payment is nothing but a share of the ordinary income of the partnership. To the extent the income of the partnership is business income, a nonresident partner's guaranteed payment must be apportioned pursuant to Section 305(a) of the IITA.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton  
Deputy General Counsel -- Income Tax